

Incentive systems for stock portfolio managers in Sweden

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Abstract

Interviews with Swedish investment professionals show that incentivising stock portfolio managers on the basis of short term returns performance is a widespread practice across several types of fund management. Among retail funds, state pension funds, and hedge funds, bonuses are predominantly based on one-year intervals. Longer-term bonus components, if offered, are generally of insignificant size. Small fund companies may offer longer-term bonuses, but then as incentive not only to produce good results but also – if results are good – to stay at the company for a longer time. Pension insurance companies also apply longer-term bonuses, possibly because they do not risk money being withdrawn by investors due to poor performance. Experimental studies are needed in order to disentangle the effects of longer-term bonuses on sustainable investments.

Key words: incentive system; compensation scheme; bonus; stock portfolio manager; short-termism

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Wages within the finance sector typically include performance-related components or bonuses. Bonus schemes are seen as important tools for owners and boards to provide incentives for employees within the organisation to produce good results (Golec, 1988). Stock portfolio managers are generally awarded bonuses conditionally on their fund producing superior returns relative either to an index or equivalent funds. Concerns are however expressed that bonuses are based on too short time intervals (O'Barr, Conley and Bruncato, 1992). Possibly, short evaluation periods impact negatively on the degree to which stock portfolio managers take environmental and social factors into account in their investment decisions. It is a relatively widespread view among fund management organisations that good environmental and social performance has positive effects on companies' long-term, albeit not on their short-term, financial performance (Jansson & Biel, 2008). This view is consistent with empirical findings indicating a time lag between, for example, initiation of emissions reduction efforts and the realisation of "bottom line" benefits (Guenster et al., 2005; Hart & Ahuja, 1996). However, if the benefits of good environmental and social practices are thought not to affect short-term financial performance, portfolio managers who are getting monitored and incentivised for their short-term performance may be unlikely to take extra-financial information into account in their investment decisions (Guyatt, 2006). Hence, even if the time horizon for the fund's investments might be long-term, portfolio managers are pushed towards shorter-term goals since that is the basis upon which their bonuses are calculated.

From a sustainable investments perspective, the above speaks for introducing longer time intervals for evaluation of stock portfolio managers. Calls for longer performance review periods have been raised for a long time. Hopkinson (1990), for example, suggested intervals of three or four years. Recently, former US vice president Al Gore suggested that portfolio

managers' pay be based on a minimum of three years' performance, a practice applied in the sustainability fund that he himself promotes. On the whole, however, the finance sector has been slow to react to such calls. Furthermore, little empirical research has been conducted to investigate the effects of prolonged evaluation periods and alternative incentive systems on investment decisions. An exception is Baker (1998) who found tentative evidence that the holding period of shares (proxy for short-termism) by UK portfolio managers declines as the frequency of performance monitoring increases, and that the holding period likewise tends to decline as the proportion of performance-related pay to total pay increases. In order to more thoroughly investigate the effects of monitoring frequency and bonus size on portfolio managers' investment decisions, more research is needed. A first necessary step is to document the incentive systems currently in use.

The aim of the present paper is to provide brief descriptions of bonus systems currently used within Swedish fund management organisations. Focus is on portfolio managers managing stock funds. Portfolio managers are responsible for investing the fund's assets, implementing its investment strategy and managing day-to-day stock trading. They may be responsible for one or several stock portfolios. A portfolio may furthermore be managed either by one portfolio manager or by several portfolio managers, each responsible for a particular segment of stocks (e.g., specific markets or industry sectors).

Unstructured interviews have been conducted with individuals working within, or with experience from, the Swedish finance sector. For reasons of anonymity, the identity of neither interviewees nor investment organisations can be disclosed. Below follows an account of how portfolio managers are incentivised among the following different types, in turn, of

organisations dealing with fund management: banks, insurance companies, state pension funds, pension insurance companies, small fund companies, and hedge funds.

Banks and other large retail fund providers

Banks and insurance companies are the main providers of consumer retail stock funds. Such funds are predominantly managed against a benchmark index, which means that the fund's returns are not allowed to deviate too much from the average returns of all stocks included in the index. As a consequence, the portfolio manager is obliged to hold stocks in all major index companies. If, for example, the index consists to 12 percent of a company A, the portfolio manager may have mandate to increase holdings of company A to 14 or decrease to 10 percent. If overstepping these boundaries, a supervising risk manager interferes. Thus, the portfolio manager has limited freedom to make stock trading decisions. The scope of the mandate to deviate from index holdings (tracking error), as well as amount of supervision, may however differ depending on the board's level of confidence in the skills of the individual portfolio manager.

Choice of benchmark index is dependent on the board's allocation decision regarding, for example, the proportion stocks relative to interest-bearing securities, and the markets/regions the fund should invest in. A strategic allocation group assigns more specific weights for each type of asset and makes decisions about, for example, to which industries the fund should have the most exposure.

As an example of how portfolio managers of stock retail funds are incentivised, a closer look is taken at one of the major Swedish banks. In this bank the portfolio managers' pay consists of one fixed and one performance-related part. Performance is evaluated on an

annual basis relative to the benchmark index. If the fund has performed better than the index, a bonus is rewarded. Its size depends on the margin by which the index has been surpassed. The bonus is awarded regardless of whether the portfolio's net asset value has diminished. The bonus system also includes a component calculated on three years' performance. The three-year component is however relatively small compared to the one-year component and is awarded annually, with a three-year lag.'

If the portfolio manager is responsible for more than one stock portfolio, the results for all portfolios are weighted together before the bonus is calculated. If a portfolio is managed by several portfolio managers, bonus size for each portfolio manager is calculated only on the segment of stocks for which he or she is responsible, in relation to a benchmark index corresponding to this particular segment.

A bonus is calculated using a pre-specified computational formula. A target amount is specified (ranging from, perhaps, 100,000 to 500,000 SEK) of how large sum the portfolio manager maximally can receive, given that some specified targets are achieved, by the end of the period. The target amount thus represents a bonus ceiling, unrelated to the fixed part of the wages.

While performance-related pay is hence predominantly based on quantitative measures, there is also scope for qualitative evaluations applied to a share representing approximately one fifth of the total bonus. This bonus share is hence based on a more subjective assessment related to, for example, how well the portfolio manager has dealt with restructuring within the organisation or performed other similar tasks that the organisation has benefited from.

An additional bonus may be awarded based on the performance of a group of portfolio managers relative to their combined benchmark index. This type of bonus is aimed at encouraging information sharing and cooperation within the company. In addition, bonuses complementing the individual and group bonuses are based on the revenues generated by the division within the company as well as the revenues to the bank as a whole.

Sizes of both the fixed and performance-related parts of wages vary substantially across different parts of the organisation and depend on seniority. Bonuses can be viewed as one part of a total remuneration package, consisting not only of one fixed and one flexible wages part, but also including pension plan, travel arrangements and other types of compensation. Although bonuses hence should not be viewed in isolation, they nevertheless often represent a considerable part of portfolio managers' compensation, sometimes amounting to several annual wages.

AP funds (state pension funds)

As is the case in the retail industry, the Swedish state pension funds (the AP funds) stock portfolio managers manage their share of the total fund portfolio against a benchmark index. However, a difference is that the bonus payments are strictly regulated by law and, as a consequence, are not as high as in other types of fund management. Thus, performance-related pay may serve as a less powerful incentive for portfolio managers than elsewhere.

For example, for AP1 the bonus ceiling is four monthly wages, while for AP3 and AP4 it is two monthly wages. For the two latter funds, bonus pay-outs are dependent on the fund as a whole producing positive results, that is, if its net asset value increases. Hence, in a

down market bonuses are not likely to be paid out. For AP1, on the other hand, bonuses are paid out even if the net asset value of the portfolio is reduced, only conditional of the portfolio manager beating the designated benchmark index. However, if the fund as a whole at the same time loses money, the bonus is cut by 50 percent.

Since the money invested in the AP funds, unlike retail funds, are not under the threat of being withdrawn due to poor performance, a short-term investment horizons would seem to be less important. However, bonus payments to portfolio managers are within the AP funds nevertheless predominantly calculated on an annual performance basis. This may be due to the fact that even short-term underperformance by an AP fund is quickly noted and reported in the mass media, resulting in a bad reputation of how the state poorly manages citizens' future pensions.

Pension insurance companies

Pension insurance companies seem to differ from most other types of fund management in that portfolio managers receive performance-related pay based on somewhat longer time periods. This may reflect the longer time horizons for investments that are inherent in pension insurance.

One Swedish pension insurance company serves as an illustration. In this company, portfolio managers may receive a bonus in addition to the fixed wage component. This bonus is partly based on the performance of the company, partly based on individual performance. Company performance is assessed on three measures. Firstly compared to competitor insurance companies, secondly relative to a benchmark index, and thirdly based on the relation between portfolio value and *pension dept*, that is, the amount promised to be paid out

to holders of the insurance. Company performance determines the size of the common pool of bonus payments to be divided among employees.

The company only holds one large portfolio consisting of stocks, interest-bearing securities, and real estate. With regards to the stock investments, responsibility is divided among several portfolio managers managing different industry sectors or markets. Each portfolio manager is evaluated against his or her benchmark index, corresponding to the area of responsibility. Individual bonuses are paid out if index is beaten, even if the net asset value of the portfolio has diminished due to a downmarket. However, in such years the total bonus pool is diminished and bonuses may be lower.

Bonuses are paid out annually primarily based on the portfolio's performance over the preceding two-year or three-year period. Although the true investment horizon for investments is 20-30 years, a maximum three-year timeline is hence used as the basis for bonus payments since this timeline is considered "fathomable", that is, possible to imagine, while bonuses based on longer evaluation periods are deemed less likely to serve as effective incentives.

Some bonus payments depend on annual performance, but then predominantly related to qualitative performance and subject to discretionary assessment. Bonuses for portfolio managers have a ceiling of one-year fixed wage, but still represents on average 30-60 percent of the total wage payments. Whether the portfolio manager invests within the risk limits of the investment policy laid out by the board is controlled on a daily basis. Hence, extra bonus payments cannot be earned by "bending the rules". However, unlike what is the

case with, for example, retail funds, the portfolio manager is free to deviate from index holdings as long as he or she keeps within the designated risk mandate.

Small fund companies

Small fund companies may offer consumer retail funds, but often their largest investors are institutions and large pension funds. Bonus systems for small fund companies may to a larger extent target long-term performance since these companies depend on good long-term records for attracting investor clients (usually institutions), while for example banks, on the other hand, have better opportunities to sell their funds to private investors through their extensive distribution network, more independently of historic performance. Hence, the incentive systems in small fund companies are often explicitly designed to attract and keep competent staff over longer time periods. Bonus systems are therefore in many cases discretionary such that performance-related payments to portfolio managers are not calculated by means of pre-specified computational formulas but instead vary at the discretion of the fund owner, who allocates or withholds bonuses (subject to approval of the board) depending on what is deemed beneficial for the fund company.

One small Swedish fund company will serve as an example. In their case, performance is not measured in relation to an index, but instead compared to how equivalent competitor funds perform. Individual bonuses are paid out if the portfolio manager's fund performs better than competing funds, even if the net asset value of the fund has decreased. However, in down markets the total pool of bonus payments to be paid out to the fund company's staff decreases, in some cases (e.g., in 2008) with as much as 30 percent. Although the total revenue of the company hence constitutes a ceiling for the total bonus pool, no bonus ceiling is applied to individual portfolio managers.

Individual bonuses are paid out not only on the basis of one-year performance but also, for example, on three and five-year bases. In order for the company to keep skilled portfolio managers within the company, earned bonuses may not be paid out directly, but instead invested in the fund in order to be paid out to the portfolio manager at a later date. If dismissed from the job, the portfolio manager receives the earned long-term bonus (if dismissal was not prompted by explicit wrongdoing). However, if leaving the company for another job, earned bonuses are not paid out.

A portfolio manager with a good long-term performance record is not penalized by one year of poor performance. Conversely, new portfolio managers will not necessarily receive the bonus for one year of good performance since this may depend on chance. Long-term bonuses constitute a significant part of the wages. While the company admits to paying fixed wages “well below industry average”, bonus payments to their top portfolio managers are among the highest in Sweden.

Hedge funds

In hedge funds, investors (frequently pension companies and other institutions) typically lock in their investment for a specified period of time. As a result, the time horizon for hedge funds is generally longer than that of other funds.

Normally investors pay a fixed management fee representing one to two percent of the invested amount and are guaranteed at a minimum the risk-free rate of return (normally two percent), a so-called “hurdle rate”. Of any excess returns, the fund company generally receives 20 percent in performance fee, while remaining returns go to the investors. In some cases, the performance fee may amount to as much as 35-50 percent of excess returns.

The excess returns makes up a bonus pool to be divided among fund owners and employees. In small funds, owner and portfolio manager may be the same person. How large percentage of excess returns the portfolio manager receives may vary depending on seniority and is subject to negotiation with the fund owner. However, after percentage is specified, no upper ceiling is set. This arrangement can hence result in huge bonuses for portfolio managers, sometimes corresponding to several annual wages, to be added to the fixed salary. The fixed salary component, covered by the fixed management fee, is defined as a fixed percentage of the net asset value of the portfolio, and hence also varies with performance, albeit less so than the bonus.

Whether a bonus is paid out depends not on performance relative to index or competitors, but rather on absolute returns, that is whether the portfolio has increased in value. Bonuses within hedge fund management are dependent on financial gains being generated. Bonus payment is therefore equivalent to revenue division. Performance is evaluated and bonuses paid out in annual cycles. However, since one or two years of poor performance means the fund is losing money, net value of portfolio assets must rise above the “high water mark”, that is, above the previous highest value, in order for bonuses to be paid out. This means that one year of good performance does not result in bonuses being paid out if the performance does not fully compensate for preceding years’ underperformance. The performance fee does hence not kick in until the fund’s net asset value exceeds its previous highest value. This represents a difference compared to other types of fund management, where bonuses are based solely on the present year’s performance and independently of the absolute value of the fund.

Also, bonuses cannot be paid out before the investor’s “lock-in” period is ended. When it becomes apparent that consecutive years’ underperformance will make bonuses

unlikely to be paid out in a foreseeable future (hence making it difficult for the fund to keep competent staff), the fund is often terminated and in some cases restarted with a clean slate.

Discussion

The present interview study shows that incentivising stock portfolio managers on the basis of short term returns performance is a widespread practice in Sweden across several types of fund management. Among retail funds, state pension funds, and hedge funds, bonuses are predominantly based on one-year intervals. Longer-term bonus components, if awarded, are generally of insignificant size. Small fund companies offer longer-term bonuses, but then as incentive for staff not only to produce good results but also – if results are good – to stay at the company for a longer time. Pension insurance companies also apply longer-term evaluation periods; possibly due to the fact that they do not (as opposed to retail funds) risk money being withdrawn by investors due to poor performance.

Frequent monitoring may put restraints on portfolio managers' ability to apply long-term investment strategies that imply taking social and environmental factors into account (Guyatt, 2006). It is therefore important to investigate whether modifying such incentive systems is one viable method of counteracting short-termism within the finance sector. This survey documenting current practice serves as a basis for starting to investigate the possible effects of introducing longer evaluation periods for portfolio managers. Some issues need and can be disentangled experimentally.

Firstly, it is important to show that bonuses make portfolio managers perform better. Evidence suggests that bonuses indeed have this effect (Golec, 1988). However, do rewards in the more distance future serve as equally effective performance incentives as rewards closer

in time? One of the interviewees stated that their organisation deemed monitoring intervals longer than two to three years ineffective as a consequence of not being “fathomable” to the employees. This claim warrants empirical scrutiny. Related to this, an important question is how much larger a distal bonus needs to be than a proximal in order to have the equivalent effect on motivation. Quite sizeably, one might suspect, considering findings from the vast body of psychological research investigating the rate with which people discount far-future outcomes relative to the present (for a review, see Frederick, Loewenstein, & O’Donoghue, 2002).

Secondly, positing that an incentive system could be designed so that a long-term bonus would be equally motivating as a short-term bonus, how will this then affect the portfolio managers’ investment choices? In analysing UK portfolio managers’ trading behaviour Baker (1998) found that the holding period for shares declines as the frequency of monitoring increases. This may imply that longer monitoring intervals make portfolio managers more inclined to view stocks’ value development in a longer perspective and hence less susceptible to adjusting trades to short-term fluctuations. In other words, they may become less myopic (Benartzi & Thaler, 1995). An alternative interpretation is that long-term incentives simply are not as motivating as short-term incentives. Experimental studies are needed to disentangle the effects of longer evaluation intervals on stock portfolio managers’ myopic tendencies, their risk attitudes, and their resulting trading behaviour.

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